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2013 ARITA Terry Taylor Scholarship Findings

A sample review of Deeds of Company Arrangement under Part 5.3A of the Corporations Act

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In recommending the introduction of voluntary administration, the 1988 Harmer Report described the reform as 'worthwhile and a considerable advantage over present procedures if it saves or provides better opportunities to salvage even a small percent of the companies which, under the present procedures, have no alternative but to be wound up.'[1] In keeping with the notion of facilitating *alternatives* for insolvent companies, the Harmer Report foreshadowed the notion of an 'arrangement' as one of the main features of the proposed voluntary administration procedure.[2] This was to become the deed of company arrangement ('DOCA'). The modest ambitions expressed in the Harmer Report appear to be borne out by the results currently being delivered by voluntary administrations and DOCAs. While DOCAs appear be something of a limited success, their use and outcomes raise legitimate questions as to whether the level of returns currently being achieved for creditors might be improved by legislative reform.

The 2013 Terry Taylor Scholarship project entailed a review of a random sample of 72 executed DOCAs which were effectuated between 1 August 2012 and 31 July 2013. This review was undertaken with the intention of producing a 'snapshot' of current practices and trends pertaining to DOCAs – ie, average (or typical) rates of dividends paid, the outcomes or goals DOCAs customarily achieve, the profile of the companies executing DOCAs and the average duration of DOCAs. The purpose of this review was to empirically assess the use and effectiveness of DOCAs in order to provide a valuable profile of one of the key outcomes of the Part 5.3A voluntary administration process and inform the ongoing debate about the success or otherwise of Australia's voluntary administration regime. An empirical review of the operation of Part 5.3A of the *Corporations Act 2001* (Cth) ('the Act') is timely given that Australia's corporate rescue regime recently marked its 20 year anniversary.

* The author sincerely thanks those insolvency practitioners and firms who generously provided data upon request. Without their assistance the author's research would not have been possible.

[1] ALRC 45 – General Insolvency Inquiry, 1988, Vol 1, Part II ('Company Insolvency'), Ch 3, 29. Part 5.3A of the Corporations Law (now the *Corporations Act*) commenced on 23 June 1993.
[2] Ibid, 31.

Recent ASIC statistics reveal that while the average annual numbers of both voluntary administration appointments and DOCAs have decreased since 2009, DOCA appointments have not decreased as markedly as voluntary administration appointments.[3] Indeed, the proportion of voluntary administrations which convert to DOCAs appears to have increased, further reinforcing the important role of DOCAs in Part 5.3A's operation.

The sample

A customised report was obtained from ASIC which listed all 350 'effectuated' DOCAs between 1 August 2012 and 31 July 2013. From those 350 DOCAs, 72 DOCAs were randomly selected for review (broadly sampled across the 12 month period).[4]

The rationale for sampling a recent pool of *effectuated* DOCAs was to provide a more informative and current picture of both how DOCAs are used and their *outcomes*. A review of DOCAs on a 'start to finish' basis sheds more light on current trends than would an examination of DOCAs which have been more recently executed but remain unimplemented (ie, not yet effectuated).

Data was obtained through a combination of requests of practitioners and the purchase of documents from ASIC.

Sample Review Findings

Breakdown of DOCA companies by company size

In terms of distinguishing companies by size, there are various views as to how to define or identify a small to medium-sized company (or business).[5] For the purposes of this sample review of DOCAs, reference was made to s 45A of the Act which requires two of three threshold criteria to be met for the definition of a small proprietary company to apply - ie,

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[3] Statistics sourced from ASIC's 'Australian insolvency statistics' (Series 2) released in May 2014 (available at https://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Statistics)

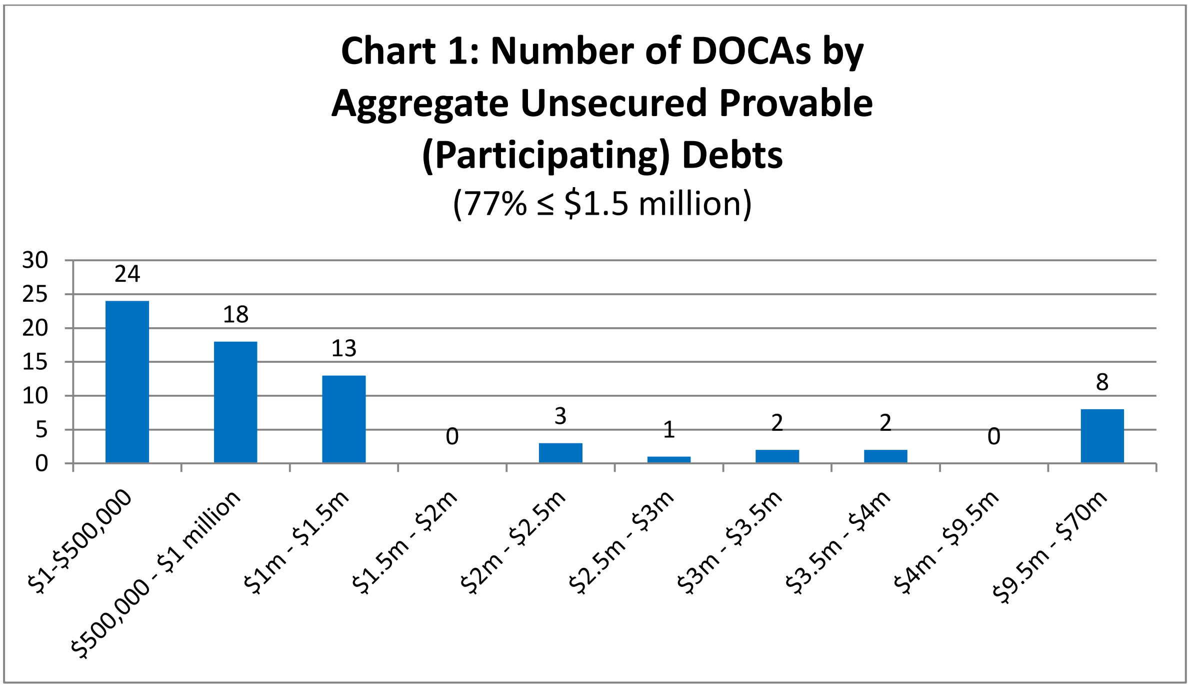
[4] It is understood that a sample of around this size produces respectably 'robust' results - ie, a confidence interval of 10.31 percent with a 95 percent confidence level. The author acknowledges the generous assistance of Ms River Paul, Statistician with the Australian Financial Security Authority ('AFSA') for her valuable input on the author's proposed sampling methodology.

[5] In ASIC's Report 372 'Insolvency statistics: external administrators' reports (July 2012 to June 2013)' a company's size is determined by the number of full time equivalent ('FTE') employees (p 17). The report states that '[i]n 2012-13, 80.8% of reports related to companies with less than 20 employees'.

that the company (and any entities it controls) has consolidated revenue of less than $25 million, consolidated gross assets of less than $12.5 million and fewer than 50 employees.[6]

For an alternative yardstick, the sampled DOCAs were also analysed according to the level of aggregate, ordinary unsecured, provable debts to which the respective DOCA responded. The findings were striking in that 77 percent of DOCAs each addressed total participating (ordinary) unsecured claims against their respective DOCA funds of $1.5 million or less. It should be noted that in 87 percent of cases, related-party claims were excluded from participating in the DOCA fund. Therefore, the aggregate ordinary unsecured claims participating in the DOCAs usually appeared to represent the body of 'arms-length' creditors.

The profile of the sampled deed administrations in terms of aggregate ordinary unsecured debts of the relevant companies is reflected in Chart 1.



Applying one or both of the above criteria – ie, the s 45A thresholds and the unsecured participating debts threshold of $1.5 million – 85 percent of the sampled DOCAs appeared to relate to 'small company insolvencies' at the time of the appointment of voluntary administrators.

[6] As a comparative reference point, it is worth observing that for the purposes of the small company moratorium (CVA) regime in Schedule A1 to the *Insolvency Act 1986* (UK) the notion of a 'small company' is determined by three similar threshold criteria, two of which must also be met to render a company eligible for the regime. These three criteria are in turn drawn from s 382(3) of the *Companies Act 2006* (UK).

Weighted average dividend returns from DOCAs

By reference to the final Forms 524 lodged with ASIC in respect of the sampled DOCAs, a weighted average dividend return to ordinary unsecured creditors was calculated.

Across the sampled DOCAs, aggregate dividend payments to ordinary unsecured creditors totalled $15,155,664. Total provable (participating) ordinary unsecured claims in the sampled deed administrations amounted to $258,439,932. This produced a weighted average dividend of 5.86 cents in the dollar.[7] Five 'outliers' were identified and after their exclusion the recalculated weighted average dividend was 7.55 cents in the dollar for ordinary unsecured creditors (ie, $11,546,118 of aggregate dividend payments against $152,958,600 of aggregate participating provable claims).[8]

The weighted average/median dividend findings are summarised in Table 1 below.[9]

Table 1: Weighted average (and median) dividend returns to ordinary unsecured creditors under 71 sampled DOCAs effectuated between 1 August 2012 and 31 July 2013

<table>
<tr><td rowspan="2">Weighted Average Dividend
Including outliers</td><td colspan="2">5.86 cents in the dollar (71 DOCAs)</td></tr>
<tr><td>Small Companies
9.7 c/$ (61 DOCAs)</td><td>Large Companies
4 c/$ (10 DOCAs)</td></tr>
<tr><td rowspan="2">Weighted Average Dividend
Excluding outliers</td><td colspan="2">7.55 cents in the dollar (66 DOCAs)</td></tr>
<tr><td>Small Companies
13.9 c/$ (60 DOCAs)</td><td>Large Companies
3.7 c/$ (6 DOCAs)</td></tr>
<tr><td>Median Dividend
(71 DOCAs)</td><td colspan="2">$40,000 (Median dividend payments)
$733,230 (Median total participating unsecured debts)
=
5.4 c/$ median dividend return</td></tr>
</table>

[7] This included 12 DOCAs under which no dividend was ultimately paid to ordinary unsecured creditors.
[8] Excluding outliers and all DOCAs under which no dividend was paid to ordinary unsecured creditors (56 DOCAs), the weighted average dividend to ordinary unsecured creditors was 7.9 cents in the dollar.
[9] One final Form 524 for a 'creditors' trust DOCA' was excluded from the total sample of 72 due to its non-disclosure of ultimate dividend payments.

Section 439A projections versus final dividend returns

In around 73 percent of cases the sampled DOCAs generated the sort of final return which creditors could reasonably have expected on the faith of the projected dividend stated in the s 439A report (remembering of course that s 439A reports provide informed estimates and do not guarantee outcomes). That is, 73 percent of DOCAs produced a final dividend which exceeded, met, or only just (negligibly) fell short of, the projected dividend return set out in the preceding s 439A report.

Of the s 439A reports which projected a DOCA dividend return in comparison with liquidation, 77 percent projected a nil return (or the possibility of a nil return) to ordinary unsecured creditors in the event of a winding up.

Costs of voluntary administrations and DOCAs

Across 41 s 439A reports pertaining to small companies, the *average* remuneration of the administrators - for the period from their appointment to the execution of the subsequent DOCA – was $54,670. The *median* remuneration for these 41 voluntary administrations was $31,500, which may be a more reliable indicator of the level of fees typically charged in a small company voluntary administration. Across 70 final Forms 524 the *average* remuneration of the deed administrators was $97,141 while *median* remuneration for the deed administrations was $28,772 (which again may be a more reliable indicator of the level of fees typically charged for the administration of a DOCA).

Lifespans of DOCAs

The *median* duration of the 72 DOCAs sampled - ie, the period between their execution and effectuation - was 11.25 months. (The median duration would probably reflect the more typical lifespan of a DOCA.) The *average* duration of the sampled DOCAs was 18.2 months.

Post-DOCA status of the sampled DOCA companies (as at 16 May 2014)

As can be seen in Table 2 below, most of the companies which entered into the sampled DOCAs remain registered with only 21 companies (out of the 72 sampled) either deregistered or currently subject to a process of impending deregistration. The author understands that this phenomenon may be attributable to the perceived tax effectiveness of a residual corporate shell (including any related party debts which may not have been released or extinguished by a DOCA). However, this matter may warrant further research.

Table 2: Post-DOCA Status of Sampled DOCA Companies (as at 16 May 2014)

Status	**No.**	**%**
Registered	46	64%
Deregistered	20	28%
Strike-off in progress	1	1%
External Administration	5	7%
Total	**72**	**100%**

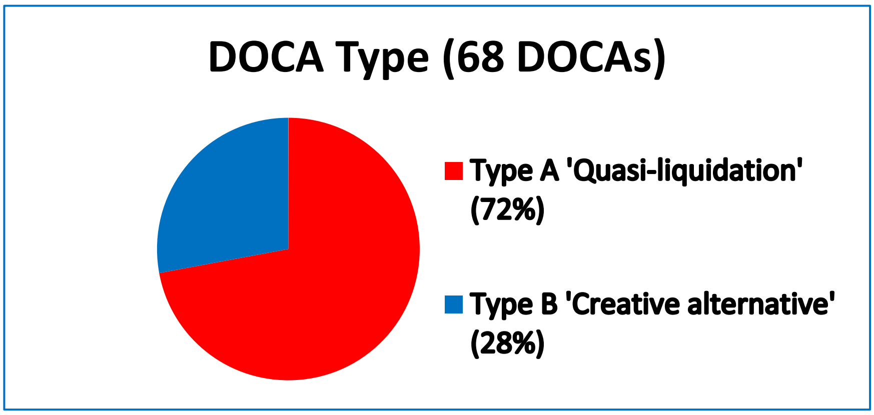
Prevalent 'types' of DOCAs: Genuine rescues and workouts or pragmatic compromises?

In short, instances of the preservation or rescue of companies or their businesses in a trading sense under a DOCA were in a clear minority (though not negligible). Of the 68 DOCAs substantively reviewed, only 28 percent appeared to involve substantial trading of the business through or under the DOCA. Indeed, in only eight of those instances did the terms of the DOCA appear to contemplate a contribution from the trading profits of the business.

Of the 72 percent of DOCAs which did not entail any substantial trading-on of the business through the deed administration, the form of DOCA was invariably a 'quasi-liquidation' composition, comprising the features or terms set out in Chart 2. The other 28 percent of DOCAs – the 'creative alternatives' - provided for companies to substantially trade-on and achieve a rescue or continuation of the business in some shape or form for the benefit of both creditors and other stakeholders in the business (eg, directors, equity holders and/or employees). The manner of company/business rescue or workout varied among these 'creative alternative DOCAs'.

The profile of the objectives, outcomes and 'types' of the 68 sampled DOCAs substantively reviewed is set out in Chart 2.

Chart 2: Summary of sampled DOCA 'types' (objectives/outcomes)



TYPE A

'Quasi-liquidation' DOCA

49 DOCAs (incl 2 creditors' trusts)

- Composition by way of compromise;
- Business usually not traded on through/under DOCA (or only very limited, 'wind-down' trading);
- Returns from asset/property realisations improved, enhanced or augmented by 3rd party contributions and/or exclusion of related party claims (not otherwise forthcoming in liquidation);
- Liquidation averted in exchange for improved or more certain return under DOCA;
- No business rescue;
- Company may still remain registered;
- 3.6 cents to 6.6 cents in the dollar weighted average dividend return (depending on outliers).

TYPE B

'Creative alternative' DOCA

19 DOCAs (incl 5 creditors' trusts)

- Trading-on composition;
- White-knight investor, purchaser or directors make (or guarantee) contribution to DOCA fund (or creditors' trust) from which dividend is paid for release of unsecured claims, facilitating either purchase/restructure or clean slate for directors;
- Alternatively (or in combination), some sort of workout for benefit of creditors, sometimes DOCA expressly providing for contributions to DOCA fund from trading profits);
- Exclusion of related-party claims in DOCA fund usually agreed to enhance outcome for unsecured creditors;
- 11.1 to 16.7 cents in the dollar weighted average dividend return (depending on outliers).

In 73 percent of the 'quasi-liquidation' DOCAs there appeared to be negligible company assets which would (or could) generate any substantial return for unsecured creditors, let alone sustain trading. Indeed, across the entire sample of s 439A reports which were obtained, in 73 percent of instances the s 439A report projected a 'nil return' to unsecured creditors (or a significant possibility thereof) in the event of a winding up. As reflected in Chart 2, the 'creative alternative DOCAs' appeared typically to yield a higher ultimate return for ordinary unsecured creditors. It is perhaps self-evident that where a company still has a semblance of a trading business to speak of when it enters voluntary administration, the administrator and stakeholders have more to work with in procuring a favourable outcome.

Of course, where a business is rescued and continuity of employment is achieved for workers, the ultimate return to unsecured creditors may not necessarily be the sole criterion against which to assess the 'success' or otherwise of a given DOCA. The broader economic and social implications of corporate or business rescue are relevant considerations but beyond the scope of this particular research.

Other noteworthy observations

Some other findings from the sample of DOCAs are worthy of specific mention:

- In 59 out of the 68 DOCAs reviewed (ie, in 87 percent of cases) related parties were excluded from participating in the distribution of the DOCA fund, associated creditors' trust or deed administration property;
- All but one of the DOCAs provided for a full release of creditors' claims upon effectuation of the deed (the one exception was a holding deed which ultimately saw the business preserved/rescued and all unsecured creditors paid 100 cents in the dollar);
- Excluding 3 extremely 'short-term DOCAs', 75 percent of DOCAs provided for the managerial control of the company to revert to the directors upon execution of the DOCA.

Analysis and Conclusions

Part 5.3A: A Modest Success?

There has been a deal of recent (healthy) debate devoted to the question of the 'success or failure' of the Part 5.3A voluntary administration regime. It is contended that looking merely at the raw numbers of 'rescued' businesses and companies against the numbers of companies entering external administration is a somewhat simplistic perspective. As the Harmer Report alluded to, no corporate rescue regime can resuscitate every company in financial distress (nor should such a regime aim to do so). In the author's view, we should not be aspiring to a threshold or quota of corporate or business rescues according to some centrally-planned economic policy. (In any event, how is a desirable level of successful corporate rescues in a free market economy determined?) Above all else, Part 5.3A was designed to provide more *alternatives* – ie, a new path or means to better insolvency outcomes which might not have been available had the law remained as it stood prior to Part 5.3A's commencement.

The outcomes of DOCAs as they are currently being used – at least according to this modest sample review – support the conclusion that alternatives more favourable than liquidation *are* being achieved, as was the stated intention of the Harmer Report. Most of the sampled DOCAs improved the ultimate return to unsecured creditors compared with what was likely to eventuate in the liquidation scenario. In a minority, but still significant number of cases (28 percent), a DOCA not only improved the bottom line result for creditors, but also supporting ongoing trading and the preservation or rescue of the company's business in some shape or form. The weighted average dividend return to unsecured creditors from the sampled DOCAs (5.86 to 7.55 cents in the dollar) is modest, but liquidations which yield no return at all for unsecured creditors are legion. Success is always in the eye of beholder, but one can legitimately contend that the goals of the Harmer Report have been (and are still being) achieved through Part 5.3A and DOCAs. Whether the voluntary administration regime can be further *improved* is a separate question.

The 'one-size fits all' nature of Part 5.3A: Is a streamlined SME regime worth considering?

The modest weighted average return achieved from the sampled DOCAs begs the question whether creditors pay too high a price for the Part 5.3A process (eg, through practitioner remuneration and costs). Are all the features and safeguards of Part 5.3A worthwhile in light of the size of companies which commonly utilise a DOCA? This point is not directed towards the charging practices of insolvency practitioners (important though that is) but rather the Australian approach of the appointment of independent external administrators who are required to have little involvement with the companies of which they and their staff must assume control. The cost of process and independent control may be significant in the context of a small company. Do the modest returns generated by DOCAs justify a rethink of whether a 'debtor in possession' or more streamlined model might better serve Australian small company insolvencies?

The small company moratorium procedure introduced in the UK in 2000 is a quasi-debtor-in-possession procedure, in that the company's directors maintain managerial control and a nominee insolvency practitioner monitors affairs while an arrangement proposal is put to creditors.[10] However, this procedure has not been widely embraced in the UK, arguably because of the prevalence of pre-packaged administrations. UK directors of SME companies who are able to purchase back their business on the first day of a voluntary administration have little incentive to explore the prospect of negotiating a 'workout' arrangement with creditors via the small company statutory moratorium.[11] Australia, with its innate resistance to pre-packaged administrations, might be more receptive to a small company moratorium procedure.

If Australia were to consider the concept of a small company insolvency procedure, some reflection would be required as to the appropriate eligibility thresholds, possibly setting them lower than the criteria provided in s 45A of the Act. An aggregate unsecured debt eligibility threshold might be considered in framing a small company insolvency regime, along the lines of that which currently exists for debt agreements under Part IX of the *Bankruptcy Act*. The findings of this sample review of DOCAs may suggest $1.5 million of unsecured debts as a suitable level at which to set such a threshold.

However, the typical small company voluntary administrator appears to charge only around $30,000 in remuneration for the period between appointment and the execution of a DOCA. One might query what real value stands to be gained in the way of practitioner-related cost savings for small company insolvencies. Typical administrator remuneration for the voluntary administration period equates to around 3 cents in the dollar in dividend terms if ordinary participating claims were around $1 million. Will a streamlined small company administration (or moratorium) procedure really provide a dramatic benefit in the way of improved returns? The potential gains from modest cost savings need to be carefully balanced against the potential abuse of a new, streamlined SME procedure.

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[10] See Keay & Walton, "*Insolvency Law: Corporate and Personal*" (3rd ed) 2012, Bristol, Jordan Publishing, 157 for an outline of the small company moratorium procedure in Schedule A1 to the *Insolvency Act 1986* (UK).
[11] See Walters A and Frisby S, 2011, 'Preliminary Report to the Insolvency Service into Outcomes in Company Voluntary Arrangements', p 17.

Promoting early intervention by SME directors: The holy grail of turnaround management?

This sample review of DOCAs observed that in around half of all cases there were very limited assets on hand by the time that an administration of the company was in train. The realities of the situations reflected in the s 439A reports and DOCAs suggest that there is often little left in the way of a trading business to accommodate any outcome for creditors other than a simple composition which 'beats' the likely return in a liquidation scenario (often zero). This sample review reinforces the point often made by practitioners that the consequences of procrastination by SME directors of distressed companies are just as determinative of outcomes as are the nuances of the voluntary administration procedure.[12] No rescue regime can realistically be expected to resuscitate corporate patients already deprived of a pulse.

Closing Comment

Empirical research is a necessary process in order to properly observe and reflect upon the actual outcomes and operation of our insolvency laws. It is the author's hope that this modest sample review of DOCAs and its findings play a role in providing but one perspective on the outcomes and effectiveness of Part 5.3A, thereby making a contribution to the ongoing debate as to the calibration of Australia's corporate rescue laws.

The full version of the report of the findings of the 2013 Terry Taylor Scholarship sample review of DOCAs can be accessed on the ARITA website at [URL]

[12] For example, see Paul Burges, 2012, 'A stitch in time: early intervention in a corporate context' *Commercial Law Quarterly* 26(3) 10.